Chapter 6

Ensuring a Balanced Financial Regulatory Landscape

Although it has been more than a decade since the financial crisis of 2008, its consequences continue to be felt. It revealed the financial sector's vulnerability to instability. And it also exposed shortcomings in the government's support for financial institutions that exacerbated the crisis. This experience vividly demonstrated the enormous consequences that can result from systemic financial crises if they are not properly addressed, and it revealed the need for measured reforms that could strengthen the financial system without imposing regulatory burdens that do little to enhance financial stability.

Unfortunately, the reforms spelled out in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act fell far short of these standards. In a rush to respond forcefully to the financial crisis, the Dodd-Frank Act became law in 2010 without there having been sufficient study of the factors that led to the crisis, nor of the costs and benefits of its provisions. Too many of Dodd-Frank's provisions were redundant, unnecessarily complex, and overreaching in their application. As we argue in this chapter, the results of this flawed approach to regulatory reform were an increase in the regulatory burden and heightened uncertainty. We believe this situation exacerbated the slowest pace of economic growth in any U.S. expansion since 1950.

From its start, the Trump Administration has maintained a focus on creating and implementing a more measured approach to financial regulation that can preserve stability while addressing the shortcomings of the Dodd-Frank Act. Two weeks after taking office, President Trump issued an Executive Order outlining seven "Core Principles for Regulating the United States Financial

System." This Executive Order also directed the U.S. Department of the Treasury to determine the extent to which current laws, regulations, and other policies promote—or inhibit conformance to—these Core Principles. Thus far, the Treasury has released four reports on the state of regulation that have resulted in more than 300 specific policy recommendations. In addition, the Treasury has released reports dealing with the operation of the Financial Stability Oversight Council and the Orderly Liquidation Authority, the resolution facility created by the Dodd Frank Act.

Action has quickly followed. On May 24, 2018, the President signed into law one of the single most important pieces of deregulation of his Administration to date: the Economic Growth, Regulatory Relief, and Consumer Protection Act, also known as S.2155. As this chapter explains, this law reduces the regulatory burden in a number of ways, but without affecting the safety and soundness of the financial system.

This chapter begins with a summary of some of the events that led up to, and marked the culmination of, the financial crisis of 2008. These events epitomize some of the policies that needed to be addressed in the wake of the crisis. The second section describes the 2010 Dodd-Frank Act and how it fell short in a number of ways in restoring the full capacity of the U.S. financial industry. The third section outlines this Administration's approach to financial reform, which directly addresses the problem of systemic risk without undermining the banking industry's ability to support the economy and contribute to the prosperity of the American people.

The Causes and Consequences of the 2008 Systemic Crisis

The sequence of events that led up to the 2008 financial crisis and accounts of how the crisis unfolded have been explored in great detail elsewhere (e.g., Financial Crisis Inquiry Commission 2011; FDIC 2017). Although many policies and practices exacerbated the crisis—government policies that focused on increasing homeownership at any cost, credit-rating agencies falling asleep at the switch, weak underwriting standards, risky mortgage structures, and a misplaced faith that the housing market would always go up, to name a few—this chapter focuses on examples of crucial regulatory failures that led to the crisis.

Reinhart and Rogoff (2009) define a systemic banking crisis as the result of either (1) bank runs that lead to bank failures, or (2) the failure of one or more important institutions that results in a string of additional failures. Systemic financial crises have been shown to render a nation's banking system unable to carry out its fundamental role in the economy (Reinhart and Rogoff 2009). Because banks are critically important agents of the monetary system, systemic crises can have very large, adverse effects on real economic activity—and real people. In recent decades, banking activities have increasingly migrated to nonbank financial institutions, such as money market funds, hedge funds, and a variety of other investment vehicles. To the extent that these nonbank institutions fund themselves with short-term liabilities, they are also subject to runs that threaten the financial system's stability.

The Boom/Bust Cycle in Residential Real Estate

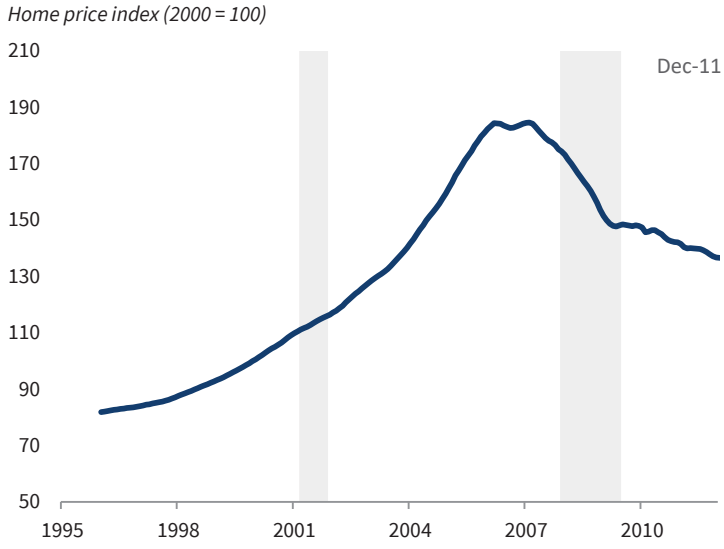
As we discuss later in this chapter, the historic rise in U.S. home prices between the mid-1990s and the mid-2000s and the historic decline in home prices that ensued constituted a sequence of events that resulted in the financial crisis of 2008. But these were by no means exogenous events that arose outside the financial system. Instead, the rise in home prices was fueled by an ample supply of mortgage credit at favorable rates and, starting in 2004, an unprecedented relaxation of mortgage lending standards.

While home prices were rising, virtually every group involved in the financial system was reaping short-term benefits. Mortgage lenders originated large volumes of loans. Homeowners saw increases in the value of their homes. Home builders saw record sales. Homebuyers were able to obtain credit on relaxed terms, with a minimum of due diligence. Housing investors were able to finance multiple homes at once, and mortgage investors earned high yields in what was otherwise a low-yield environment. This self-reinforcing cycle of optimism only lasted as long as home prices continued to rise. At the national level, home prices more than doubled between 1996 and 2006. In a number of large coastal markets, home prices increased even faster during this period, growing by an average of 207 percent among the six coastal cities included in the S&P CoreLogic Case-Shiller 10-City Composite Home Price Index (figures 6-1 and 6-2).

During 2003, U.S. first-lien mortgage originations totaled $3.7 trillion, of which the vast majority ($3.3 trillion) were prime mortgages, government mortgages, or jumbo mortgages.[1] These totals remain all-time highs for mortgage originations in these categories. Mortgage refinancings hit $2.8 trillion in 2003, or 76 percent of total mortgage originations, both of which were also historic highs. But as mortgage interest rates rose in 2004, originations of prime mortgages fell by more than half. In that same year, the mortgage lending

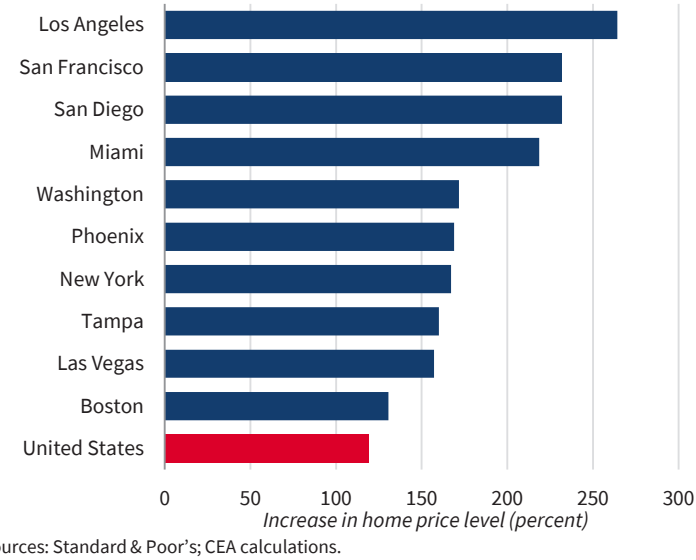
[1] Jumbo mortgages are those that are generally made to prime borrowers, but exceed the conforming size limit of the government-sponsored enterprises and must be privately financed.

Figure 6-1. S&P CoreLogic Case-Shiller Home Price Index, National Value, 1996–2011



Source: Standard & Poor's.
Note: Shading denotes a recession.

Figure 6-2. Increase in S&P CoreLogic Case-Shiller Home Price Index by City, 1996–2006



Sources: Standard & Poor's; CEA calculations.
Note: Data represent the increase in home prices between December 1996 and December 2006.

business abruptly shifted to riskier subprime and Alt-A mortgages. Between 2004 and 2006, more than $2.7 trillion in subprime and Alt-A mortgages were originated—three times the dollar amount originated in the previous three years. Many of these would eventually be backed by the U.S. government and by taxpayers, who were often on the hook for losses in these portfolios (see box 6-1).

When credit standards were lowered, the market became hotter, and home prices rose even faster. Home prices had been growing faster than disposable personal incomes since 1999, but they accelerated to double digits in 2004 and peaked at an annual rate of more than 14 percent in 2005. Despite the risks inherent in subprime, Alt-A, and nontraditional mortgage loans, these mortgages performed very well as long as home prices continued to rise. In 2006, subprime mortgages past due by 90 days or more made up just 3.1 percent of total balances.

Average U.S. home prices peaked in February 2007. During the next five years, they would decline, on net, by 26 percent. Price declines were even more pronounced in cities where nontraditional "affordability" loans had increased the most, again, some of which were on the books of the government-sponsored enterprises (Fannie Mae and Freddie Mac), and where home prices had risen the fastest before 2007. To compete for its lost "market share," the Federal Housing Administration of the U.S. Department of Housing and Urban Development lowered its down payment requirements and relaxed its underwriting standards. Just as all parties involved appeared to prosper in the self-reinforcing cycle of the housing boom, virtually all parties, including taxpayers, would be adversely affected by the self-reinforcing housing bust that started in 2007.

By one measure, the total value of U.S. home equity declined by more than half between 2006 and 2009, trimming total household net worth by $6.3 trillion. Because subprime borrowers could not repay when their loans reset, and could not qualify to refinance when the value of their home declined, subprime mortgage performance declined sharply. By 2009, subprime mortgages past due by 90 days or more quadrupled, to 13.6 percent. The annual number of mortgage foreclosures nearly tripled, on average, from 831,000 between 2004 and 2006 to 2.4 million between 2008 and 2011. Though not all these foreclosure proceedings would result in the repossession of a home, those that did introduced deadweight costs of up to 20 percent of the value of the property (Capone 1996). Forced sale of repossessed properties played a substantial role in the self-reinforcing cycle that was driving home prices downward (figures 6-3 and 6-4).

The ultimate losses to the holders of mortgage credit have been somewhat difficult to estimate. These losses accrued to federally insured banks, to thrifts and credit unions, to the government-sponsored enterprises (GSEs)—including Fannie Mae and Freddie Mac—and to holders of private mortgage-backed

Box 6-1. Defining Subprime, Alt-A, and Nontraditional Mortgages

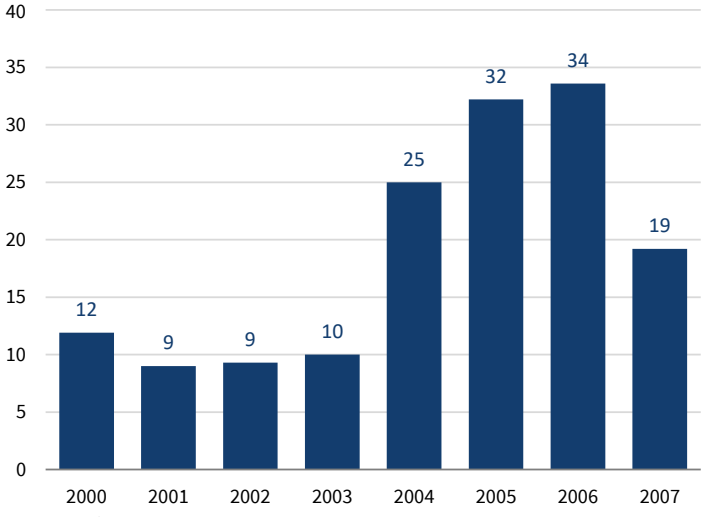
Subprime, Alt-A, and nontraditional mortgages were categories of high-risk loans that included terms or underwriting standards that made them much riskier than prime loans. Subprime mortgages were made to households with limited or impaired credit histories. Most of them came with a relatively affordable "introductory rate" for the first two or three years and imposed heavy penalties on borrowers who chose to refinance during that introductory period. After this introductory period, the interest rate was reset to a much higher level, which the borrower could avoid only with a refinancing and by paying additional fees.

"Alt-A" was the label given to a class of mortgage loans that were generally made to households with stronger credit histories. But they often eased underwriting standards, including the requirement for borrowers to document their incomes. Of the Alt-A mortgages originated in 2006, 83 percent required little or no documentation of borrower income. Nontraditional mortgages were a large subset of Alt-A loans that allowed borrowers to defer repayment of principal through interest-only, payment option, and negative-amortization structures.

Both before and after the housing crisis, subprime, Alt-A and nontraditional mortgage loans were considered too risky to make. This judgment was validated by the exceptionally high default rate they incurred during the

Figure 6-i. The Rise in Subprime and Alt-A Loans Leading into the Financial Crisis, 2000–2007

Share of total mortgage originations (percent)



Source: Inside Mortgage Finance.

housing crisis. Among subprime loans made in 2007, 36.6 percent defaulted within 24 months. For Alt-A loans, cumulative defaults for that vintage were 25.1 percent, while for prime loans the default rate was 6.7 percent. Figure 6-i shows the rise in these types of mortgages in the years leading up to the financial crisis.

securities (MBSs), which largely backed subprime and nontraditional mortgages. It was the private MBSs and the derivatives based on their value, which had been distributed to institutions and investors around the world, that made the toll of mortgage losses especially difficult to estimate. Nonetheless, the total losses on U.S. mortgages and mortgage-related instruments during the crisis have been projected to range into the hundreds of billions of dollars.[2]

Implicit Government Support That Undermined Market Discipline

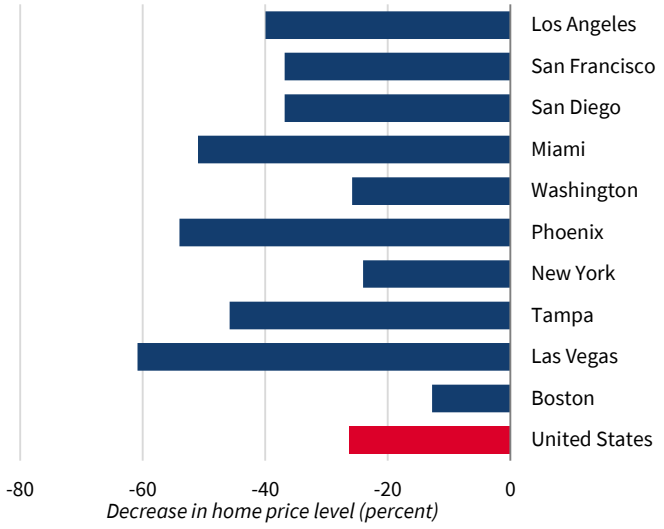
Mortgage finance had evolved a great deal in the half century leading up to the crisis. As recently as 1975, depository institutions (banks and savings institutions) held 74 percent of total mortgage debt outstanding. It was in the 1970s that the GSEs began to build a substantial market share in financing mortgage credit. Their share of mortgage loans outstanding hit 10 percent in 1974, 30 percent in 1985, and more than 50 percent in every year between 1994 and 2003.

The growing presence of the GSEs in the mortgage market arose in part from the financial and technological innovations that favored their wholesale approach. A provision of the Tax Reform Act of 1986 defined the real estate mortgage investment conduit as a tax-preferred vehicle for funding mortgages in securitized pools, funded by a wide range of investors. The resulting division of mortgage origination, funding, and servicing has been called the "unbundling" of mortgage finance. But their ultimate competitive advantage came from their close relationship with the Federal government. The GSEs are exempt from State and local taxes and from Federal regulations on the issuance and holdings of securities. Investors perceive an implicit Federal guarantee on the MBSs they issued, and their securities have exemptions or are given another type of special status under a number of Federal regulations. These implicit guarantees and exemptions resulted in a subsidy that totaled about 40 basis points in the precrisis period, and benefited both mortgage borrowers and GSE shareholders (Ligon and Beach 2013).[3]

[2] For example, see reports by the Financial Crisis Inquiry Commission (FCIC 2011, xvi) and the International Monetary Fund (IMF 2008, 50).

[3] A Heritage Foundation study cites research by Passmore, Sherlund, and Burgess (2005) and other sources.

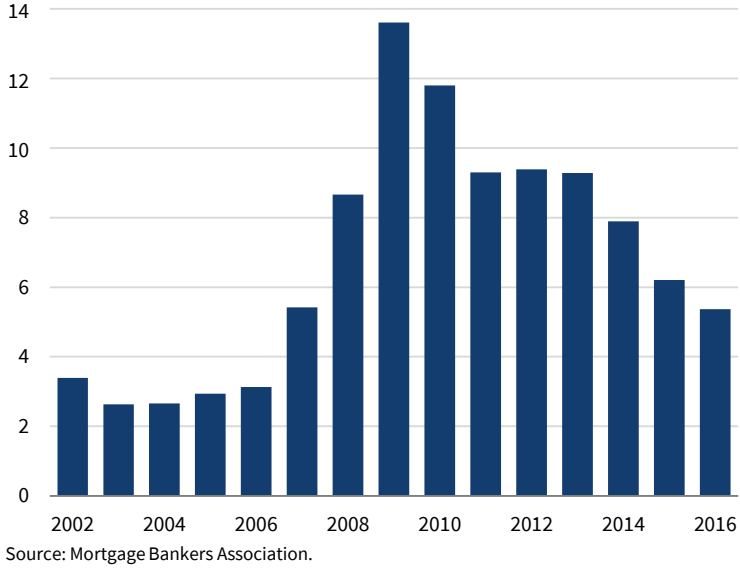
Figure 6-3. Decrease in S&P CoreLogic Case-Shiller Home Price Index by City, 2006–11



Sources: Standard & Poor's; CEA calculations.
Note: Data represent the decrease in home prices between December 2006 and December 2011.

Figure 6-4. Percentage of U.S. Conventional Subprime Mortgages 90 Days or More Past Due, 2002–16

Share 90 days or more past due (percent)



Source: Mortgage Bankers Association.

Because of the implicit guarantee, the GSEs were able to operate with higher leverage than other financial institutions while still maintaining confidence in the strength of their MBS guarantee. Studies find that in 2007, they operated with leverage that was significantly greater than their commercial bank competitors (Baily, Litan, and Johnson 2008). These factors provided an implicit subsidy to the GSEs that enabled them to grow and that may have encouraged them to take on more risk. Besides expanding their securitization businesses, the GSEs also took advantage of their implicit guarantee and low capital requirements to issue subsidized debt to fund investments in mortgage loans that they retained on their balance sheets. Their combined debt obligations totaled $2.9 trillion at the end of 2007. According to a 2010 report by the International Monetary Fund, "[GSEs] were pivotal in developing key markets for securitized credit and hedging instruments, but their implicit guarantee and social policy mandates [exacerbated] a softening in credit discipline and a buildup of systemic risk" (IMF 2010, 10).

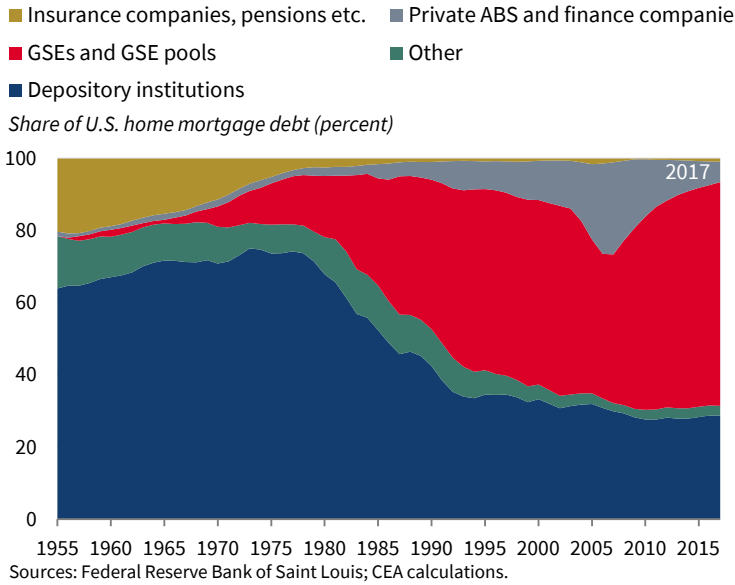
Wallison (2011) cites the expansion of the GSEs' affordable housing goals in the late 1990s and early 2000s as one factor that led the GSEs to lower their lending standards. He also maintains that though it was difficult to estimate year-by-year GSE purchases of subprime and Alt-A loans, they made up 37 percent of loans held or securitized by the GSEs as of June 2008.[4] However, other data and research suggest that private MBSs had a large role in financing the increase in subprime and Alt-A lending starting in 2004 (Belsky and Richardson 2010). Originations of subprime and Alt-A mortgages during their peak years of 2004–6 totaled $2.7 trillion. In those same years, issuance of private MBSs backed by subprime and Alt-A loans totaled $2.1 trillion, accounting for 78 percent of originations in dollar terms (figure 6-5).

The sources of risk introduced through private MBS mortgage conduits were similar to the sources of risk for the GSEs. They operated with high rates of leverage, which in this case was the small share of the mortgage pools that were backed by the subordinate tranches that were in a first-loss position. In addition, their portfolios were characterized by imperfect information that created moral hazard, or the incentive to take on risk at the expense of their investors. This imperfect information was in part the product of the overoptimistic credit ratings that were applied to private MBSs by credit-rating agencies. For example, of all the private MBSs rated by Moody's in 2006 as investment grade (Baa or higher), 76 percent would ultimately be downgraded to junk status. The MBS downgrades by Standard and Poor's (S&P) and Fitch were of similar magnitude (FCIC 2011).

Another factor that amplified the risks were the many structured investment vehicles (SIVs) that held private MBSs and funded them with short-term, wholesale, market-based instruments. Gary Gorton (2007) is generally credited

[4] Wallison (2011) cites work by Pinto (2010) that estimates the GSEs' total exposure to subprime and Alt-A loans.

Figure 6-5. Share of U.S. Home Mortgage Debt Held by Financial Sectors, 1955–2017



Sources: Federal Reserve Bank of Saint Louis; CEA calculations.
Note: GSEs = government-sponsored enterprises. ABS = asset-backed security.

with identifying the role of the SIVs in financing subprime mortgages, their funding strategies, and how they exacerbated the financial crisis. Brunnermeier and others (2009) also examined the relationship between asset funding and systemic risk, with a focus on how financial regulations have historically failed to distinguish between short-term and long-term funding sources.

With this portfolio structure, the SIVs performed the functions of maturity transformation and credit enhancement that are traditionally carried out by banks. As with banks, this transformation created value and returns, but also proved to be subject to runs during a period of financial distress. During the precrisis years, the SIVs had substantial exposures (about 25 percent) to private MBSs, and an even larger exposure (more than 40 percent) to other financial institutions (FCIC 2011). They held stable valuations and were able to obtain funding through the financial markets as long as home prices continued to rise. These stable valuations were suddenly cast into doubt in the summer of 2007, when home prices began to fall and the subprime and nontraditional mortgages that backed the private MBSs began to default in large numbers. It was then that investors in the repurchase agreements (repos) and commercial paper that funded SIVs became much more reluctant to continue doing so. They required vastly higher "haircuts" on their collateral, or simply stopped investing in SIVs altogether. When investors' confidence collapsed, the large banks and investment companies that had created the SIVs faced significant

liquidity demands themselves, having provided credit and liquidity lines to the SIVs. Though they were not legally obligated to do so, these sponsors frequently stood behind the SIVs they had sponsored, because they were also heavily dependent on repo financing (figure 6-6).

The rise of off-balance-sheet financing of subprime and nontraditional mortgages was a leap into the dark for financial markets. Trillions of dollars in credit were indirectly provided to U.S. homebuyers by investors from around the world. When home prices were rising, and when mortgage defaults were low, this private nonbank financing arrangement was thought by many to distribute U.S. mortgage risk in an optimal way. However, when home prices began to decline, it quickly became clear that the private MBSs that were financing subprime and nontraditional mortgage loans were much riskier than anticipated. Moreover, because private MBSs had come to play a substantial role as collateral for short-term borrowing, their downgrades created a major disruption in the overnight lending market. The "run on repo" that resulted was reminiscent of the destructive bank runs that had been associated with previous systemic crises in the United States and around the world.

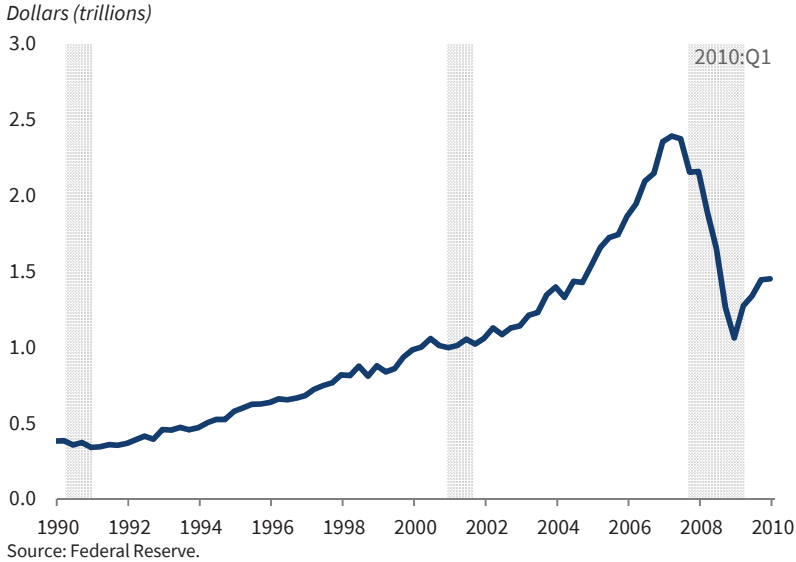
An Ineffective and Uncoordinated Regulatory Response

Regulatory arbitrage that moved risky mortgage lending away from regulated depository institutions and toward private and governments-sponsored conduits played a role in undermining market discipline. But financial regulators also failed to detect and respond to emerging risks in the mortgage markets.

At the end of 2007, regulated depository institutions still held $3.1 trillion in mortgage loans. Regulatory authority over mortgage lending by banks and thrifts was divided between four Federal regulators and 50 State regulators. This divided authority tended to undermine these regulators' ability to prevent or respond to the emerging crisis. For example, State measures intended to reduce predatory mortgage lending during the precrisis years were overridden by the Office of Thrift Supervision and the Office of the Comptroller of the Currency (OCC), which successfully claimed that their authority preempted that of the State regulators.

Even before Dodd-Frank imposed a flurry of new postcrisis regulations, regulators already had a number of authorities that could have addressed emerging risks in mortgage lending before the crisis. The 1968 Truth in Lending Act gave the Federal Reserve the authority to establish rules governing mortgage lending that would apply to any type of lender. Although the Fed did implement this authority in its 1969 Regulation Z, the rule's enforcement was left to a multiplicity of Federal and State regulators (FCIC 2011). The 1994 Home Ownership and Equity Protection Act gave the Federal Reserve additional powers to regulate abusive and predatory lending practices that especially affected low-income borrowers. This was perhaps the farthest-reaching Federal authority to address emerging risks in mortgage lending. However, this power was

Figure 6-6. Gross Repurchase Agreement Funding to Banks and Broker-Dealers, 1990–2010



Source: Federal Reserve.
Note: Data are as of December 9, 2010, publication. Shading denotes a recession.

not exercised until 2008, when the housing crisis was already well under way (Lincoln 2008).

Regulatory capital standards that were in place before the crisis proved to be insufficient to preserve the financial viability of a number of large, complex banks during the crisis. Moreover, the risk-weighting approach of these capital standards actually created incentives to take on more risk. The Basel I standards put in place in 1992 turned out to promote bank holdings of MBSs as opposed to holding whole mortgage loans. Under these standards, pass-through MBSs issued by the GSEs were given a low 20 percent risk weight. A 2001 amendment tied these risk weightings in part to agency credit ratings, which also generally resulted in a low risk weight for GSE obligations. These low risk weights permitted the holders of GSE bonds to hold less capital than if they had actually held the underlying mortgage loans, which had risk weights of 50 to 100 percent. Moreover, the GSEs' 20 percent MBS risk weight also applied to private MBSs after 2001, provided that they received high ratings from the credit-rating agencies. As discussed above, the structured approach to funding private MBSs generally enabled their senior tranches to receive a AAA rating, qualifying them for the 20 percent risk weight.

Wallison (2011) estimates that this disparity in risk weighting resulted in a reduction in risk-based capital requirements from 4 percent for banks holding whole mortgages to just 1.6 percent for banks holding MBSs. Although holding

securities as opposed to loans could enhance the liquidity of bank portfolios, their liquidity ultimately depends on the quality of these securities. As discussed above, it was the sudden illiquidity of private MBSs and the externalities this introduced in the financial markets that exacerbated the financial crisis.

Like the vast majority of their private sector counterparts, most regulatory economists also did not realize the risks that were building in housing markets and mortgage finance until it was too late. One factor may have been the sudden change in mortgage lending practices that occurred in 2004. Introducing large volumes of high-risk mortgages accelerated the rate of increase in home prices, making the housing market an apparent source of strength in the economy. But to the extent that the price increases were the product of risky mortgage lending, they could not be sustained. When home prices leveled off, and then began to fall in 2006, defaults and foreclosures rose sharply. The resulting instability in the housing and mortgage markets would eventually snowball into what became a systemic financial crisis.

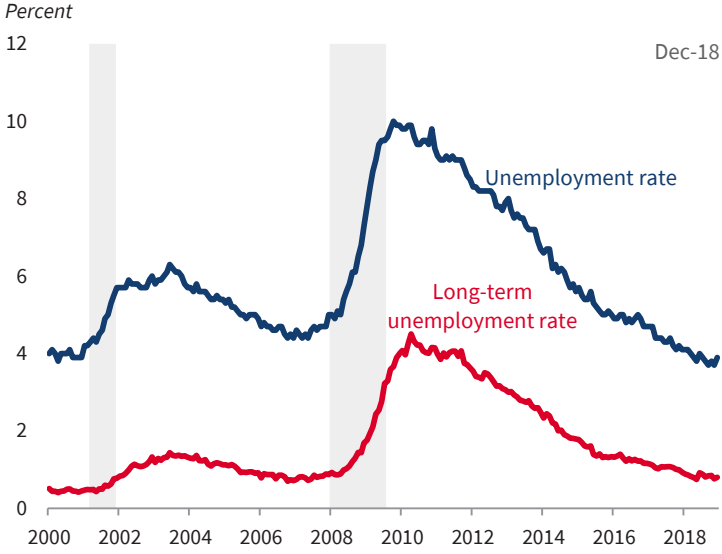
The Consequences of the Financial Crisis

The financial crisis of 2008 was an explosion of the risks that had been building in mortgage finance and the financial system as a whole. Rescues of large banks and nonbank financial companies during previous crises had helped to create the perception that the largest banking organizations would be deemed "Too Big to Fail," and that their investors would be protected from loss in a crisis. These expectations were shattered on September 15, 2008, when Lehman Brothers, a $639 billion investment bank, did not receive such assistance and was forced to declare Chapter 11 bankruptcy. Lehman Brothers' bankruptcy meant that many of its counterparties around the world would not be made whole, and would find their claims tied up for years, leading to large losses.

Fannie Mae and Freddie Mac were placed in a government conservatorship on September 6, 2008. In combination, Freddie and Fannie held or guaranteed $5.2 trillion in mortgage debt, or about 45 percent of U.S. households' total mortgage obligations. The GSEs continue to operate in conservatorship more than 10 years after the crisis.

At the height of the crisis, three extraordinary programs of government support were implemented to restore liquidity to financial markets, solidify the capital base and the banking system's funding, and enable financial institutions and markets to make credit available to finance an economic recovery. First, the Federal Reserve expanded greatly on its traditional lender-of-last-resort function by introducing a series of special liquidity facilities that made loans available for longer terms, to a wider range of institutions, and on a wider range of collateral than it had ever done through the discount window. Second, Congress initially authorized the sum of $700 billion for the Troubled Assets Relief Program—known as TARP—to assist financial institutions in dealing with the large volumes of impaired assets on their balance sheets. And third, in

Figure 6-7. National and Long-Term Unemployment Rate, 2000–2018



Sources: Bureau of Labor Statistics; CEA calculations.
Note: Shading denotes a recession.

October 2008 the FDIC instituted its Temporary Liquidity Guarantee Program to help stabilize the banking industry's funding base.

These three assistance programs represented an unprecedented expansion of government support for the banking system. In total, the financial commitments behind these programs has been estimated at about $14 trillion, although the programs' net cost was a small fraction of this amount. The programs can be described as successful in addressing the immediate dangers posed by the crisis. But over the longer term, they set new precedents for government support that undermine market discipline in banking. Moreover, they violate the principle that financial institutions themselves—and not taxpayers—should be responsible for their losses.

The shockwaves of the 2008 financial crisis caused enormous harm to real economic activity. From peak to trough, real GDP fell by more than 4 percent, making this the deepest U.S. recession since the 1930s. In the six months after September 2008, the industrial production index for durable materials fell by 21 percent—its largest decline in more than 50 years. The monthly unemployment rate peaked near 10 percent in October 2009, the highest rate since June 1983. Around the time of the crisis, the United States experienced the longest stretch of unemployment above 8 percent, over three years, since the Great Depression. From peak to trough, nearly 8.7 million nonfarm workers lost their jobs (figure 6-7).

The net economic effects of the crisis have generally been expressed as the shortfall between potential U.S. GDP and actual GDP in the wake of the crisis. Studies that have projected the long-term effect of the crisis on GDP generally arrive at estimates of forgone economic activity that exceed $10 trillion (GAO 2013; Luttrell, Atkinson, and Rosenblum 2013). The enormous scale of these effects have become an important consideration in evaluating the impact of the Dodd-Frank Act, which was passed as a response to the crisis.

The Consequences of the Dodd-Frank Act

After the 2008 financial crisis, there was a push to reform the regulation of the U.S. financial system. The large economic dislocations resulting from the crisis were still obvious, as were the potential benefits of policies that could reduce the likelihood and cost of a future systemic crisis. However, in the rush to implement reforms, the costs and benefits of various regulatory reforms were not properly analyzed and weighed. In 2009, the Financial Crisis Inquiry Commission (FCIC) was created to examine the causes of the crisis. Its final report was released in January 2011—six months *after* sweeping reforms were made under the Dodd-Frank Act. The failure to construct an appropriate framework for considering costs and benefits *before* passing legislation led to reforms that were often overreaching, misguided, and inefficient. This failure to analyze—fully and properly—the likely effects of new regulatory policies made the costs of the crisis greater than they needed to be. Researchers have found evidence of a number of regulatory problems that have emerged in the postcrisis period, including regulatory arbitrage, rising compliance costs, and financial market illiquidity.[5]

Addressing Systemic Risk

The Dodd-Frank Act aimed to address key factors that had undermined market discipline and helped trigger the systemic crisis. It created new processes in an attempt to identify and respond to emerging threats to financial stability. Title I of the act created the Financial Stability Oversight Council, chaired by the Secretary of the Treasury and including as members the heads of eight financial regulatory agencies, an independent insurance expert, and five nonvoting members. The council was given detailed criteria for determining whether a company will be subject to Federal Reserve supervision and the application of enhanced prudential standards. Separately, Dodd-Frank also imposed enhanced prudential standards on all bank holding companies with assets of $50 billion or more.

Title I of Dodd-Frank also required every banking company with at least $50 billion in assets and every designated nonbank financial company to hold

[5] See Choi, Holcomb, and Morgan (2018); Peirce, Robinson, and Stratmann (2014); and Roberts, Sarkar, and Shachar (2018).

more capital and liquidity to ensure their safety and soundness, and to file an annual resolution plan that could be used as a guide for their rapid and orderly resolution through bankruptcy (figures 6-8 and 6-9).

Title II of Dodd-Frank established an orderly liquidation process to quickly and efficiently liquidate or otherwise resolve a large, complex financial institution that is close to failing. It established a two-part test, under which the Secretary of the Treasury establishes that the institution is in default or is in danger of default, and then evaluates the systemic risk that would be involved with such a default. Title II requires that bankruptcy first be considered as a means to resolve the failed institution. If bankruptcy is deemed unable to bring about an orderly resolution, Title II provides the FDIC with receivership powers that apply to bank holding companies or nonbank financial companies. It establishes a fixed order of claims that helps to ensure that the executives, directors, and shareholders of the institution stand last in line to receive payment.

The overarching goal of the Dodd-Frank reforms—which sought to end Too Big to Fail, strengthen capital and liquidity requirements, and restore market discipline—was to prevent a future bailout by U.S. taxpayers. However, the generally one-size-fits-all approach that Dodd-Frank took in pursuing these goals turned out to be unnecessarily costly and, in some cases, counterproductive. Moreover, an overreliance on regulatory discipline as opposed to market discipline has turned out to rely too much on the judgment of bank regulators, which are not infallible (Viscusi and Gayer 2016).

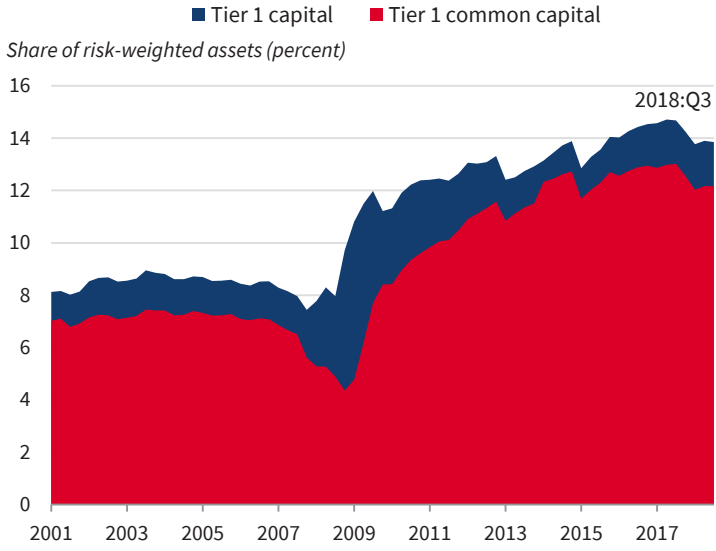
Dodd-Frank's Ill-Considered Approach

The economist Paul Romer once said that a crisis is a terrible thing to waste, and the Obama Administration paraphrased him in the wake of the 2008 financial crisis, placing government deeply into the markets, especially the financial ones. The complex series of events that led to the crisis called for careful study before reforms were rushed out the door. Legislation passed in May 2009 created the FCIC to examine the causes of the crisis. The FCIC's report and conclusions, released in January 2011, did not receive bipartisan support, but they did provide first-hand accounts of a wide range of bankers, regulators, and analysts that could have been considered as reforms were being planned.

Unfortunately, Congress passed, and President Obama signed, the Dodd-Frank Act even before the FCIC released its report. Congress rushed out this 849-page piece of legislation, which mandated 390 new rules and regulations. Dodd-Frank would stand out from previous financial legislation in the degree to which it mandates how American businesses can and cannot conduct the financial transactions that are vital to both their well-being and that of the U.S. economy.

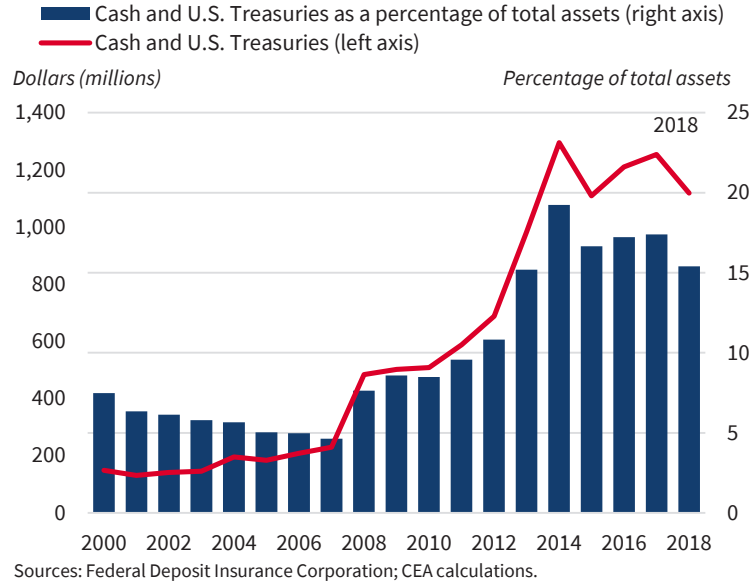
Even in the dense world of Federal regulation, Dodd-Frank stands out in its size, complexity, and redundancy. It addressed regulatory policy at a

Figure 6-8. Tier 1 Capital Ratios of U.S. G-SIBs, 2001–18



Source: Federal Reserve Bank of New York.
Note: U.S. G-SIBs = global systemically important banks; these are banks with assets of more than $500 billion.

Figure 6-9. Liquid Assets of U.S. G-SIBs, 2000–18



Sources: Federal Deposit Insurance Corporation; CEA calculations.
Note: U.S. G-SIBs = global systemically important banks; these banks have assets of more than $500 billion.

number of agencies; created a new regulatory body, the Consumer Financial Protection Bureau (CFPB); and merged another agency, the Office of Thrift Supervision, out of existence. It required the Federal financial regulatory agencies to create 390 new rules, of which 280 have been finalized, and to complete more than 70 studies. A 2017 study, using data from RegData 3.0, showed that Dodd-Frank had placed 27,278 new restrictions on the U.S. financial industry and the economy as a whole (McLaughlin, Francis, and Sherouse 2017).[6]

The Trump Administration has made it a priority to address the regulatory overreach created by the Dodd-Frank Act, while also striving to ensure the safety and soundness of the Nation's financial system. The discussion here addresses the consequences of some of Dodd-Frank's most important regulatory reforms and how they have in many cases failed to resolve the issues that led to the financial crisis.

Dodd–Frank's Consequences

Although it has been eight and a half years since Dodd-Frank was signed into law, it still has not been fully implemented, due in large part to its complexity. However, the initial results of this partisan legislation are not encouraging.

Until a recent uptick in growth, the postcrisis economic recovery has been atypically weak. The economic expansion began in July 2009, and at the end of 2018 it had concluded its 114th month, making it the second-longest expansion in U.S. history. Until 2017, it was also among the most tepid expansions on record. Real economic growth averaged 2.2 percent between the middle of 2009 (the start of the expansion) and the end of 2016. This marked the slowest growth in any expansion since the National Income and Product Accounts were introduced in 1947.

Before 2007, the severest downturn during this era had been the double-dip recession of 1980–81 and 1981–82. A combination of a pro-growth agenda—including tax relief, deregulation, and price stability—led the Reagan Recovery that ensued. This long period of growth started off with two years of growth that averaged 6.7 percent, and average annual growth of 4.3 percent during the entire expansion.

The election of President Trump in November 2016 produced an immediate increase in small business confidence that has remained in place ever since.[7] The 4-quarter moving average of real GDP growth has risen for 9 consecutive quarters, exceeding 3 percent for only the fifth time in the 37 quarters of the expansion. In the second quarter of 2018, after the enactment of the Tax Cuts and Jobs Act (TCJA), real economic growth rose to an annualized rate of

[6]RegData 3.0 measures the number of regulatory restrictions in a textual analysis that identifies words and phrases that have been added to the *Federal Register* that are generally associated with a required or prohibited activity.

[7] Further discussion of the effect of the 2016 election on business confidence and the effect of the 2017 Tax Cuts and Jobs Act on economic activity can be found in chapter 1 of this *Report*.

more than 4 percent for the first time in four years. The recovery of business confidence, hiring, and investment spending since 2016 suggests that we will see higher potential growth in the years ahead.

The slow pace of growth in the first eight years of the expansion was, at least in part, attributable to the persistent effects of the severe 2007–9 recession. But the regulatory requirements imposed during this period, including those mandated by the 2010 Dodd-Frank Act, were also responsible for holding back the pace of the economic recovery.[8] A 2015 study projected that Dodd-Frank's requirements and the compliance costs it continues to introduce will result in a reduction of about $895 billion in GDP between 2016 and 2025 (Holtz-Eakin 2015).

Although the financial crisis had lingering effects throughout the economy long after the recession officially ended, additional public policy choices also played a role in slower growth than would have typically been expected after such a deep recession. Some of these policies reduced labor force participation, labor productivity, and capital investment, and thus were factors in the subpar macro performance through 2016 (figure 6-10).

Dodd-Frank was especially a factor in discouraging small business lending and mortgage lending, and in promoting consolidation among small and midsized banks (Peirce, Robinson, and Stratmann 2014). The importance of small businesses to the U.S. economy goes well beyond the roughly two-thirds of new jobs they typically create. Small businesses have traditionally been a source of strength for their communities and a source of innovation where new and different ideas can be pursued. They rely heavily for funding on community banks, which have a local focus that helps them meet the credit needs of small businesses.

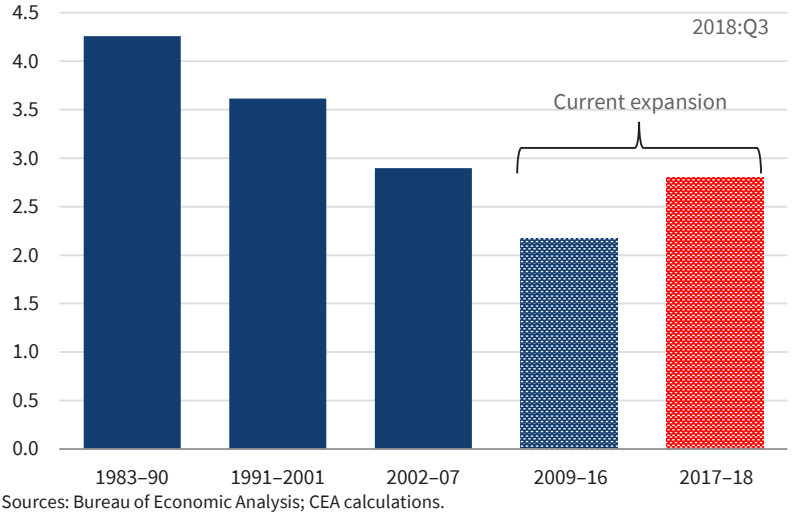
Small businesses were hit especially hard by the recession, and they recovered slowly during the early years of the expansion. Since mid-2010, small loans to farms and businesses held by FDIC-insured institutions have declined by 2 percent, while total farm and business loans have increased by more than 50 percent. The monthly *Small Business Economic Trends* report, which is published by the National Federation of Independent Business, recorded some of its lowest annual values on record for small-business optimism during the early stages of the recovery. The federation's optimism index would rise above its long-term average only once over 116 months, ending in November 2016. Small business optimism has remained above the historical average in every month since then.

Mortgage lending has also been slow to recover since the crisis. The annual volume of purchase mortgage originations in 2017 remained below that of the peak years 2003–6. The level of mortgage debt outstanding in the third quarter of 2018 also remained lower that of the peak level reached in 2008.

[8] Chapter 2 of this *Report* includes an extensive discussion of the effects of regulation on economic activity.

Figure 6-10. Average Economic Growth By Expansion Period, 1983–2018

Compound annual growth rate



Sources: Bureau of Economic Analysis; CEA calculations.
Note: Change in real GDP is calculated from the peak to trough of expansion periods.

Moreover, mortgage finance has become increasingly dominated by the GSEs—including Fannie Mae, Freddie Mac, and Ginnie Mae—in spite of their role in the crisis. These entities have accounted for funding 81 percent of the net increase in mortgage lending over the past two years. The increasing dominance of the GSEs can be attributed in no small part to the higher requirements placed on portfolio mortgage lending and private mortgage securitization. As mandated by Dodd-Frank, the 2014 interagency Risk Retention Rule requires private issuers of MBSs to retain at least 5 percent of the credit risk in the mortgage pool, unless the loan meets the definition of a Qualified Residential Mortgage that makes it a low-risk loan. Fannie Mae and Freddie Mac are not subject to this rule while operating in conservatorship or receivership with capital support from the Federal government.

Another area of concern about Dodd-Frank is the overall increase in compliance cost it imposes, particularly on small and midsized banks. The hundreds of regulations required under Dodd-Frank, and the thousands of pages of detailed requirements included with each regulation, have raised concerns about what has come to be called "regulatory burden" (Hoskins and Labonte 2015). This burden refers not only to the marginal cost imposed by new rules but also to the cumulative increase in the number and scope of

Box 6-2. Measuring the Regulatory Burden on the Financial Sector

Banking is one of the most regulated U.S. industries. McLaughlin and Sherouse (2016) ranked U.S. industries in terms of the regulatory restrictions they face. They found that though the median industry faced 1,130 regulatory restrictions, depository and nondepository credit intermediation both faced over 16,000 restrictions. The only industries facing more restrictions were petroleum and coal production, electric power generation, and motor vehicle manufacturing.

As with total noninterest expenses, there are economies of scale in regulatory compliance. For example, Dahl and others (2018) found that mean total compliance costs were about 10 percent of total noninterest expenses in 2017 for banks with less than $100 million in assets, compared with 5 percent for banks with assets between $1 billion and $10 billion.

Regulation may also impose a wide range of indirect costs on banks and their customers that exceed the paperwork costs associated with compliance. These include the opportunity costs of loans not made and products not offered, along with effects on deposit rates offered and loan rates charged by regulated banks. Such costs not only hurt the bottom line of the bank but can also reduce the welfare of bank customers and economic activity generally.

Through the fourth quarter of 2018, community banks held just 16 percent of the total loans of FDIC-insured institutions, but they held 42 percent of the industry's small loans to farms and businesses. Recent research finds that by raising fixed regulatory compliance costs, the Dodd-Frank Act disproportionately raised the average cost of loan origination by small banks and reduced their share of small commercial and industrial loans (Bordo and Duca 2018). They further observe a relative tightening of bank credit standards on commercial and industrial loans to small versus large firms in response to Dodd-Frank.

regulations imposed on banks over time.[9] They consist of both the overhead costs of complying with a regulation and the opportunity costs of restrictions on bank activities. These costs raise concerns about their effect on both bank performance and the cost and availability of credit (see box 6-2).

[9] In the FDIC's 2012 "Community Banking Study," community bankers reported that "no one regulation or practice had a significant effect on their institution." Instead, they cited "the cumulative effects of all the regulatory requirements that have built up over time." They also explained that the increases in the regulatory cost over the previous five years could be attributed to the time spent by both regulatory specialists and employees that typically carry out other responsibilities (FDIC 2012, appendix B).

A More Measured Approach to Financial Regulation

Since its first days in office, the Trump Administration has been working to correct the regulatory overreach introduced by the Dodd-Frank Act and to restore the ability of the financial system to support growth in the economy and our Nation's standard of living.

Core Principles for Regulating the U.S. Financial System

Seven Core Principles for financial regulation were outlined in Executive Order 13772, issued in February 2017. These principles reflect a commitment to taking measures that will:

1. Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth.
2. Prevent taxpayer-funded bailouts.
3. Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry.
4. Enable American companies to be competitive with foreign firms in domestic and foreign markets.
5. Advance American interests in international financial regulatory negotiations and meetings.
6. Make regulation efficient, effective, and appropriately tailored.
7. Restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.

These Core Principles are designed to promote the ability of financial institutions to do their job of providing credit and other financial services to the U.S. economy. Under Dodd-Frank, banks have been regulated like public utilities, where government oversight boards dictate the manner in which business should be conducted. The Administration's approach is consistent with a greater reliance on market discipline and somewhat less reliance on regulatory discipline. The leaders of financial regulatory agencies that have been appointed by the Administration understand and endorse this concept. And this will make it possible for them to pursue a more coordinated and measured approach to reform that will not undermine financial stability but will make regulation simpler and less costly to implement.

Recommendations for Meeting the Core Principles

During the past two years, the U.S. Department of the Treasury has issued four reports that made detailed recommendations consistent with the Administration's Core Principles. These four reports have focused, in order,

on (1) banks and credit unions; (2) capital markets; (3) asset management and insurance; and (4) nonbank financials, financial technology (known as fintech), and innovation.

With regard to depository institutions, the Treasury has recommended a series of changes designed to simplify regulations and reduce their implementation costs, while maintaining high standards of safety and soundness and ensuring the accountability of the financial system to the American public. These recommendations are summarized and discussed in the next paragraphs. A number of these recommendations were implemented in the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018, which is generally referred to as S.2155. These cases are noted in the next paragraphs, and the overall effects of S.2155 are summarized later in the chapter.[10]

Improving regulatory efficiency and effectiveness. To address the U.S. regulatory structure, consideration should be given to changes in the regulatory structure that reduce fragmentation, overlap, and duplication among Federal financial regulators. This could include consolidating regulators with similar missions, as well as more clearly defining regulatory mandates. At a minimum, steps should be taken to increase the coordination of supervision and examination activities.

The experience of the financial crisis points to the need for improved coordination among the financial regulators. While risks were rapidly building in subprime and Alt-A lending, the need to coordinate across several regulatory agencies made it more difficult to respond in a timely way. Interagency guidance issued in 2006 and 2007 on commercial real estate lending and mortgage lending did little to discourage the riskiest nonbank lenders, but it did lead to industry concerns that regulators were placing strict caps on making loans in those categories.

To improve the regulatory engagement model, sound governance of financial institutions, where policies are developed and their implementation is monitored, is essential. Hopt (2013) emphasizes the need to clearly separate the management and control functions, and to assign committees to carry out specific governance responsibilities. The failure of board governance and oversight of their banking organizations was found to be a major impediment to risk management and a factor exacerbating the financial crisis. A successful governance model requires both highly qualified board members and a commitment to procedures that promote discipline and accountability across the organization.

The approach currently taken by regulators may not be promoting effective governance. Prescriptive regulations may tend to blur the division of responsibilities between the board and management and impose a

[10] These recommendations are paraphrased in the next subsections from the U.S. Department of the Treasury's report *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* (U.S. Department of the Treasury 2017).

one-size-fits-all approach that unnecessarily restricts banking activities and the services they provide to their customers. This is particularly problematic for midsized and community financial institutions, which have less formal governance structures. It would be helpful to clearly define the board's role and responsibilities for regulatory oversight and governance, and to do so more consistently across regulatory jurisdictions. More transparency and consistency across the agencies could help to assure all regulated banks that they are being treated fairly.

Encouraging more constructive engagement between bank regulators, board members, and managers would help to ensure that the bank itself can more effectively meet the needs of its customers while managing the risks it faces. This requires that the board be held to the highest standards when implementing regulatory compliance procedures, and that the board—not the regulator—hold management to the same standards. A step forward in improving the governance of large banks was the Federal Reserve's August 2017 proposal, now out for comment, to create a governance-rating system for banks with assets greater than $50 billion.

It is also important to enhance the use of regulatory cost-benefit analysis. As concerns about regulatory burden have increased in the postcrisis period, cost-benefit analysis has taken on a more prominent role in financial regulation. There are requirements for cost-benefit analysis in rulemaking that apply to most Federal agencies. These requirements have been outlined in Executive Order 12866 (1993), and in the subsequent Office of Management and Budget (OMB) "Circular A-4" (2003). These directives call for an analysis of proposed rules that addresses (1) the policy objectives of the proposed rule; (2) the rule's expected effects, including costs and benefits for the parties directly involved as well as externalities that are created for other stakeholders; and (3) an analysis of regulatory alternatives.

The independent financial regulatory agencies have long been exempt from oversight by OMB in most aspects of regulatory analysis. At the same time, these agencies have increasingly adopted a cost-benefit approach to rulemaking, and have devoted more resources to regulatory analysis in recent years. This analysis has been largely based on the main requirements outlined by OMB's directives.

Financial regulators are also subject to a number of legislative mandates that serve to make the regulatory process more transparent and better informed. For example, the Administrative Procedure Act established general requirements for a notice-and-comment process that keeps the industry and the public informed about proposed rules and solicits their comments, which often provides valuable information that can inform the rulemaking process. The Regulatory Flexibility Act—known as RegFlex—requires agencies to consider the impact of regulations on small entities. If a rulemaking is expected to

have a "significant economic impact on a substantial number of small entities," the agency is required to assess that impact.[11]

There is an active debate as to whether cost-benefit analysis can be a reliable guide to regulatory policy in banking and finance. Some question whether it is possible to reliably project, much less quantify, the costs and the benefits of bank regulations (Coates 2015). Given the discussion above of imperfect information and market failures in banking, it is clear that important outcomes in banking and finance depend heavily on intangible factors such as public confidence and market liquidity. Requiring strict quantification of costs and benefits in financial regulation is viewed by some as being both unrealistic and an excessive restriction on the ability of independent regulators to apply their judgment in addressing emerging risks. Others, including Sunstein (2015), contend that a useful cost-benefit analysis can still be performed, even when there are serious gaps in the available information on costs and benefits.

These two schools of thought might not be as far apart as they initially seem. The experience of the financial crisis, and the regulatory burdens that were imposed after the crisis, both point to rather obvious conclusions about the relative costs and benefits of regulations that apply to various types of institutions.

One conclusion is that regulation is relatively more burdensome for small and midsized banks than for large banks. Research has repeatedly shown that regulatory compliance costs are subject to economies of scale, as are other types of nonregulatory overhead expenses. Regulation also imposes external costs on the customers of small and midsized banks, which disproportionally include small businesses. The value of small businesses in creating new jobs and new businesses is widely recognized, and has been a motivating force behind calls for applying cost-benefit analysis to bank regulations.

Another fairly obvious conclusion from the financial crisis is that the benefits of safety and soundness regulations are exponentially higher when applied to systemically important institutions than when they are applied to small and midsized institutions. As the experience of the crisis clearly showed, the negative externalities associated with the failures of systemically important institutions included severe distress in global financial markets and enormous losses in U.S. economic activity. The magnitude and the incidence of these negative externalities largely determine the benefits of regulations that reduce the probability of failure (box 6-3).

The framework for cost-benefit analysis by financial regulators could be improved. They should be encouraged to adopt uniform and consistent methods to analyze costs and benefits, and to ensure that their cost-benefit analyses exhibit as much analytical rigor as possible. The standards of transparency and public accountability will be served by conducting rigorous cost-benefit

[11] This requirement was established under the Regulatory Flexibility Act, Public Law 96-354, 94 Stat. 1164 (5 U.S.C. § 601).

analyses and making better use of notices of proposed rulemakings to solicit public comment that is helpful in evaluating a rule's possible effects. This type of public analysis will be particularly helpful for proposed regulations that are "economically significant," as defined in Executive Order 12866.

Aligning the financial system to support the U.S. economy. With the goal of ensuring access to credit, the 2017 Treasury report on banks and credit unions identified a series of regulatory factors that may be unnecessarily limiting access to credit for consumers and businesses (U.S. Department of the Treasury 2017). Addressing these constraints on credit availability will be necessary to enable the U.S. economy to operate at its full potential. Regulatory constraints also should not be allowed to unduly restrict banks' ability to meet their customers' needs in a rapidly changing financial marketplace. The U.S. has been—and should continue to be—a global leader in introducing innovative new financial products. The regulatory environment should support this innovation while ensuring that it does not compromise the financial system's stability or fail to protect the interests of consumers.

Among the most important elements in achieving this balance are the requirements for capital and liquidity. Adequate capitalization of bank balance sheets helps to ensure that banks face market discipline that reduces their incentives to take excessive risks. At the same time, higher capital standards can limit the ability of banks to add new loans to their balance sheets. Achieving this balance is important to promoting stability while ensuring that the availability of credit is not impaired.

With regard to engaging and leading the global marketplace, the competitiveness of American financial institutions in global markets is another area that was addressed in the 2017 Treasury report. It recommended active participation by U.S. regulators in global forums, and emphasized the need for coordination among U.S. regulatory agencies. Banking is very much a global marketplace. Not only do the largest U.S. banks have interests abroad, but foreign banks have continued to play a larger role in U.S. financial markets. Coordination between regulatory jurisdictions around the world has improved since the financial crisis. On net, these trends should be seen as positive developments over the long term. The U.S. regulatory agencies should engage their counterparts overseas in ways that serve the interests of U.S. financial institutions, the U.S. economy, and the American people.

The Treasury made several recommendations addressing bank capital standards. More study is needed of the somewhat complex capital and liquidity requirements that have been placed on U.S. global systemically important banks (G-SIBs). If not properly calibrated, these regulations could place U.S. banks at a competitive disadvantage without contributing to financial stability and safe and sound banking. Additional research should explore several aspects of G-SIB regulation, including "the U.S. G-SIB surcharge, the mandatory minimum debt ratio included in the Federal Reserve's total loss

Box 6-3. Evaluating the Costs and Benefits of Bank Regulations

An example of the trade-off between benefits and costs as applied to large banks can be seen in the FDIC's 2016 final Rule on Recordkeeping for Timely Deposit Insurance Determination. This rule addresses a particular problem that the FDIC has faced in closing failed institutions in a timely and efficient manner due to the difficulty in identifying related deposit accounts from large bank systems. The problem arises in part from complex coverage rules spelled out in statutes, along with the sometimes disconnected information systems that large banks have accumulated over the years through acquisitions. The rule requires banking organizations with more than 2 million deposit accounts to improve their data systems to facilitate the calculation of the deposit insurance coverage for each account.

When the final rule was adopted, the FDIC estimated that it would apply to apply to 38 institutions, each with 2 million or more deposit accounts. Taken together, these institutions hold more than $10 trillion in total assets and manage over 400 million deposit accounts. Some, but not all, of these institutions could be considered systemically important. But the FDIC's experience in resolving institutions with so many accounts shows that it is doubtful that they could be promptly resolved unless their data systems met the standards of the rule. The result could be a significant delay in the full availability of funds to bank depositors, which threatens to reduce the confidence of other large institutions that their funds would be promptly available in a time of distress.

The benefit of the rule is measured in terms of the assurance that depositors would have prompt access to their funds as well as the confidence of depositors in other large institutions. The accuracy of any estimate of the dollar value of these benefits is doubtful at best. However, as the experience of the recent financial crisis has shown, maintaining confidence in the financial system offers potentially large benefits to the public.

The costs of complying with the rule are not negligible. Based on a consultant's estimate that is documented in the rule's preamble, the initial and ongoing costs of implementation will likely be about $386 million. This figure represents 0.25 percent of the pretax income of these banks in 2015. Another way to place these costs in context is that they represent 93 cents for every one of the 416 million accounts these institutions manage. Equally important are the potential opportunity costs that may be imposed on banks that are subject to the rule. For example, banks may shy away from the 2 million account threshold to avoid incurring the cost of implementing this rule. Though these opportunity costs are more difficult to quantify than compliance costs, these negative external effects should be taken into account when considering the potential effects of such a rule.

The decision as to whether the rule's benefits outweighed its costs was made on the basis of this information and the judgment of the FDIC's Board of Directors. Whether it is worth 25 basis points of pretax earnings for one year,

and the opportunity costs of forgone business opportunities, to enhance the stability of the financial system is ultimately a judgment call. What is important is that this judgment be informed with good information where available, and not clouded by estimates whose accuracy may be vastly overstated.

absorbing capacity . . . and minimum debt rule, and the calibration of the [enhanced supplementary leverage ratio]" applied to each banking company (U.S. Department of the Treasury 2017, 16).

The Treasury report continued to be supportive of the ongoing Basel Committee process. The goals of establishing international bank capital standards are to strengthen the capital standards that apply to G-SIBs in general, and level the competitive playing field by establishing a floor for global risk-based capital standards. The complexity of capital rules for G-SIBs remains a challenge in achieving these goals.

U.S. bank regulators will need to carefully consider the implications of any changes in the Basel III standardized approach to account for credit risk. It is important to evaluate both the possible impact on systemic risk and the effect on credit availability. Making these evaluations public as capital rules are introduced will be helpful to inform this debate as to the proper balance inherent in capital regulation.

Reducing the regulatory burden and unnecessary complexity through "tailoring." Allowing community banks and credit unions to thrive is a key aspect of the 2017 Treasury report's recommendations. Previous discussions of economies of scale in regulatory compliance and the widespread diseconomies associated with the potential failure of a systemically important institution inescapably lead to the conclusion that most community banks and credit unions are overregulated. These institutions have a role in the U.S. economy that is more important, in relative terms, than the share of industry assets they hold. For example, in 2014 there were 646 U.S. counties in which the only banking office was one operated by a community bank (Breitenstein and McGee 2015). Yet these smaller institutions pose virtually no systemic risk that would justify burdensome regulation. Moreover, they are diverse in terms of their business models and customer bases, and can benefit from less rigid regulatory requirements. These considerations have led to calls for "tailoring" regulatory requirements in banking to better meet the needs and challenges that pertain to individual institutions.

A 2017 report by the Congressional Research Service (Perkins 2017) defines tailoring as a departure from current threshold-based (typically asset-based) standards for regulation, to new standards that would (1) raise or lower the current threshold; (2) abandon numerical thresholds altogether; or (3) use

alternative methods to tailor regulation based on bank activities, capital levels, or greater regulator discretion. Introducing regulatory thresholds of this type can potentially distort the decisions made by regulated banks as they seek to maneuver around regulatory requirements. Accordingly, the more financial regulation can be tailored to match the business model and complexity of individual institutions, the more efficient the regulatory system will be in preserving safety and soundness, promoting innovation, and minimizing regulatory burden.

Examples thus far of tailoring regulation have included the expansion of size-based exemptions from a number of regulatory requirements. For example, the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018, or S.2155, simplified the capital standards applied to banks with assets less than $10 billion and exempted them from the U.S. Basel III risk-based capital system. It also raised the Small Bank Holding Company Policy Statement asset threshold from $1 billion to $3 billion. Requirements for data reporting are being relaxed for banks with up to $5 billion in assets, and the frequency of on-site examinations are being relaxed for banks with assets of less than $3 billion. And the threshold for exemption from the CFPB's ability-to-repay / qualified mortgage rule was raised from $2 billion to $10 billion.

Based in part on a Treasury recommendation, the National Credit Union Administration has raised the threshold for stress-testing requirements for federally insured credit unions from $10 billion to $15 billion in assets. The National Credit Union Administration has also raised the asset size threshold for applying a risk-weighted capital framework from $100 million to $500 million. These steps promote greater equality with bank capital requirements that apply to commercial banks of a similar size and complexity.

Refining capital, liquidity, and leverage standards. Improving, and appropriately tailoring, the regulatory standards for capital, leverage, and liquidity remain an essential element of postcrisis regulatory reforms. The 2017 Treasury report made a number of recommendations aimed at both decreasing the burden of statutory stress-testing and improving its effectiveness by tailoring the stress-testing requirements to the size and complexity of banks. The May 2018 enactment of S.2155 implemented many of these recommendations.

Section 165 of Dodd-Frank required the Federal Reserve to establish enhanced prudential standards for certain bank holding companies and foreign banking organizations and for nonbank financial companies that have been designated by the Financial Stability Oversight Council as systemically important financial institutions (SIFIs). These standards included enhanced requirements for:

1. Risk-based and leverage capital and liquidity.
2. The submission of periodic resolution plans.
3. Limits on single-counterparty credit exposures.
4. Periodic stress tests to evaluate capital adequacy.

5. A debt-to-equity limit to be applied to companies that the Financial Stability Oversight Council determined pose a grave threat to financial stability.

Section 165 also authorized the Federal Reserve to "establish additional prudential standards, including three enumerated standards—a contingent capital requirement, enhanced public disclosures, and short-term debt limits—and other prudential standards" that the Federal Reserve determined to be appropriate (Federal Reserve Board of Governors 2018, 595).

The 2017 Treasury report contained a number of recommendations to better tailor the requirements placed on midsized and regional banks—those with total assets between $10 billion and $250 billion—to the actual risk that they pose to financial stability. For the company-led annual Dodd-Frank Act Stress Test (DFAST), the report recommended raising the dollar threshold above the $10 billion level to reduce the regulatory burden placed on banks that are, in fact, not systemically important. This recommendation was largely implemented with the May 2018 passage of S.2155. Under S.2155, institutions with total assets below $100 billion are exempt from DFAST, while banks with assets between $100 billion and $250 billion are only subject to DFAST at the discretion of the Federal Reserve. This approach gives regulators the flexibility to tailor the stress-testing requirement to each bank's business model, balance sheet, and organizational complexity. It not only reduces the compliance burden of banks that are not systemically important but also relieves them from assessments related to enhanced regulation.

The Treasury report also recommended adjusting the thresholds applied under the Comprehensive Capital Analysis and Review (CCAR), and to adjust the review to a two-year cycle. Given that stress-testing results are forecast over a nine-quarter cycle, extending the CCAR review cycle to two years should not compromise the review's quality. These changes, however, are covered by separate legal authorities and will need to be implemented over time on an interagency basis.

Another important element of the 2017 Treasury report's recommendations was a proposed "off-ramp" exemption from compliance with DFAST, CCAR, and certain other prudential standards for any bank that elects to maintain a sufficiently high level of capital. Providing this choice of a simplified capital standard over a more complex standard will help to ensure that the institution is subject to capital requirements that are appropriate to its particular situation, thereby helping to minimize the regulatory cost of compliance. This, too, has largely been implemented through the Economic Growth, Regulatory Relief, and Consumer Protection Act.

In addition, the Treasury recommended that the Federal Reserve subject its stress-testing and capital planning review frameworks to public notice and comment. This type of transparency will help to inform market participants about the nature of this analysis and enable them to make more informed

decisions about the institutions that are subject to these reviews. In February 2019, the Federal Reserve finalized its implementation of enhanced disclosure of the models used in its supervisory stress test (see box 6-4).

The 2017 Treasury report also made specific recommendations related to a number of other important Dodd-Frank standards—including those related to liquidity and funding for SIFIs, the resolution plans filed by SIFIs under Title I of Dodd-Frank, the Supplementary Leverage Ratio, the enhanced Supplementary Leverage Ratio that forms part of bank capital requirements, and the Volcker Rule's limitations on proprietary trading. In each of these areas, what was originally a well-motivated attempt to address areas of risk-taking that preceded the banking crisis turned out to be an overprescribed fix that unnecessarily raised the costs of regulatory compliance. The recommendations of the 2017 Treasury report include narrowing the application of the liquidity coverage ratio and recalibrating how the Net Stable Funding Ratio and Fundamental Review of the Trading Book interact with the liquidity coverage ratio and other relevant regulations. In addition, the report showed how the requirement for resolution plans to be filed by SIFIs under Title I of Dodd-Frank could be relaxed without abandoning an important element of lowering the potential for systemic risk. This measured tailoring of regulatory requirements to match the risks that are being addressed is a fundamental element of the regulatory reform efforts that have been, and continue to be, pursued by the Administration.

Regulatory reforms enacted thus far. Having established this agenda for reform with the Economic Growth, Regulatory Relief, and the Consumer Protection Act of 2018, the Administration is concentrating on implementing it. The most prominent accomplishment to date in implementing the Administration's agenda was the May 2018 passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act (hereafter, the act), also referred to as S.2155. Unlike the Dodd-Frank Act, S.2155 garnered significant bipartisan support, receiving a 67–31 vote in the U.S. Senate and a 258–159 vote in the U.S. House of Representatives before being signed into law by the President.

The act exemplifies the shift away from the insufficiently tailored regulation found in portions of Dodd-Frank and to a more right-sized approach. These changes directly address some of the shortcomings of the Dodd-Frank Act described earlier in this chapter, and does so in four main areas, Titles I though IV of the act.

Title I provides relief to portfolio mortgage lenders who originate and hold residential mortgage loans on their balance sheet. Its expected effect will be to loosen unnecessary regulatory constraints on the availability of mortgage credit to U.S. households. Dodd-Frank had created a potential liability for banks that originated loans that later defaulted, unless those loans met the terms of the "qualified mortgage," a definition established in 2013 by the CFPB.

Box 6-4. Restoring Market Discipline in Banking

Market discipline can be promoted by equity capital requirements and practices for failed bank resolution that help to ensure that the owners of the bank are first in line to absorb losses if the bank should fail. It has proven to be a highly effective, and sometimes disruptive, means to limit risk-taking among financial institutions. Market discipline is the antithesis of moral hazard, where the costs of risk-taking are imposed on parties other than the owners of the bank. At the same time, a sudden collapse in the confidence of bank depositors and bondholders can exert enough market discipline to force the failure of the bank.

There are two basic approaches to enhancing the market discipline that discourage banks from taking on excessive risk: a minimum capital requirement, and a framework to resolve failed banks in an orderly fashion.

Minimum capital requirements represent a commitment, in advance, of private capital to absorb losses incurred by the bank. As such, this capital helps to limit moral hazard. The more capital the bank holds, the greater the share of failure cost that will be absorbed by the bank's owners before losses are imposed on other stakeholders. Other things being equal, this alignment of incentives to take risks will limit the subsidization of risk-taking bank owners and will result in a level of risk-taking that is closer to the socially optimal level. Undercapitalized banks have been cited as factors exacerbating both the savings-and-loan crisis of the late 1980s and the financial crisis of 2008 (FDIC 1997, 2017).

An orderly resolution process to resolve failed banks is another essential element of market discipline. An orderly bank resolution will impose losses on equity claims first, and then on unsecured debt, before imposing losses on uninsured depositors and the FDIC's Deposit Insurance Fund. This process helps to ensure that the equity holders that control the bank are in a first-loss position, even if their equity cannot completely cover the losses generated by the failure. An orderly resolution process for failed banks is essential for long-term financial stability. Since 1989, more than 2,000 FDIC-insured institutions have failed and have been resolved, with no losses to insured depositors.

During the recent crisis, we saw instances in which the FDIC chose *not* to impose losses on the equity and debt holders of very large and complex failing banks, and instead provided them with open bank assistance. These exceptions from normal procedures were based on concerns that imposing losses on uninsured creditors would transmit these losses to other banks and financial companies and worsen the systemic crisis. In the short run, this expansion of government support clearly helped to maintain the stability of the financial system. Over the long term, these actions could be expected to undermine market discipline, subsidize growth and risk-taking, and create competitive inequities between large and small banks. These considerations underlie the provisions of Section 1106 of the Dodd-Frank Act, which effectively ended the FDIC's authority to provide open bank assistance, even in a crisis situation.

To summarize, a regulatory approach based on market discipline must (1) create strong capital standards that limit moral hazard, and (2) enhance the ability to properly impose market discipline in the event of a failure. Historical experience shows that the ability to maintain market discipline according to these principles has been inversely related to the size and complexity of the institutions to which they are applied.

The potential liability for defaulted loans under the "ability-to-repay" provision of Dodd-Frank was thought to impose market discipline on the mortgage lending process. But it also applied to mortgage loans held on the bank balance sheet, which already faced market discipline to the extent that private capital stood first in line to cover any losses from the loan.

Title I simply extends the presumption of ability-to-repay compliance to *all* mortgages originated and held by banks and credit unions with assets under $10 billion, which will be presumed to meet the definition of a qualified mortgage. Title I also provides an exemption for depository institutions that make few mortgage loans from reporting requirements under the Home Mortgage Disclosure Act. Title I of the act defers to the judgment of the managers of small and midsized banks about the quality of the mortgages they make and hold on their own balance sheets, and steps back from having regulators make this judgment for them.

Title II's provisions are aimed at reducing the regulatory burden placed on community banks without undermining the market discipline they face. Title II exempts banks with under $10 billion in assets from the Volcker Rule, which prohibits proprietary trading by banks. This exemption reflects the fact that very few small and midsized banks engage in proprietary trading. Title II also established the new Community Bank Leverage Ratio. Banks with limited amounts of certain assets and off-balance-sheet exposures will be able to choose this relatively simple measure of capitalization and be exempted from the more complicated Basel risk-based capital standards. In its November 9, 2018, proposal to implement the Community Bank Leverage Ratio, the FDIC proposed setting the standard at 9 percent of tangible equity to total assets. An estimated 80 percent of community banks would be eligible to adopt this simplified capital standard.

The provisions of Title II are designed to simplify and streamline the regulatory standards that apply to community banks. Their relatively simple business models do not require complex regulatory approaches. And the economies of scale they face in the cost of regulatory compliance make it imperative that the standards applied to them are simple and straightforward (box 6-5).

Title III of the Economic Growth, Regulatory Relief, and Consumer Protection Act addresses a number of issues related to consumer protection.

One of these is the need to give consumers more control over their own credit reports, which are a valuable reputational asset for all Americans. Title III requires the credit reporting agencies to provide updated fraud alerts to consumers for at least a year following a security incident, and gives consumers a right to place security freezes on their credit reports for free to prevent them from being inappropriately downgraded. Credit-reporting agencies will be required to omit certain medical debts from the credit reports of U.S. veterans.

These requirements recognize the importance of the consumer financial information on which we all rely to gain access to credit. Although these provisions do not directly affect the safety and soundness of regulated banks, they do recognize the priority of fairness in handling this valuable and sensitive information.

Title IV of the act addresses what was probably the biggest cost-benefit miscalculation made in the Dodd-Frank Act. Dodd-Frank required that all banking organizations with assets of $50 billion or more be subject to enhanced prudential standards. This approach relies too heavily on asset size as a measure of systemic importance. A better measure of the systemic importance of a particular bank is the FDIC's ability to resolve the institution successfully without creating financial instability. In cases where an institution is deemed resolvable, subjecting it to heightened regulatory requirements imposes high regulatory costs but gives very little benefit in terms of preserving financial stability.

The designation carries with it a number of regulatory requirements designed to introduce regulatory discipline as well as market discipline to designated institutions. To the extent that the institution is already resolvable, there would appear to be little benefit to the designation. In a case like this, the considerable regulatory costs imposed on SIFIs are for naught.

Under Title IV, banks with $250 billion or more in assets continue to be subject to the heightened regulatory standards already imposed by Dodd-Frank. Banks with between $100 billion and $250 billion in assets are statutorily required to be subject only to the Dodd-Frank Act's supervisory stress tests, while the Federal Reserve has the ability to impose other regulatory requirements as appropriate. Banks with assets between $50 billion and $100 billion will no longer be subject to the heightened regulatory requirements under Dodd-Frank.

The regulatory relief provided to midsized and regional banks will be an important step toward enhancing the banking system's ability to meet the credit needs of the U.S. economy. At the end of 2018, there were 32 banks with between $50 billion and $250 billion in total assets. Together, they hold 22 percent of the banking industry's assets. But few or none of them can truly be deemed to pose a systemic risk. As a result, the benefits of subjecting them to heightened prudential requirements, in which they are likely to fall far short of the costs they incur by being regulated in this manner, are questionable.

Box 6-5. Factors Driving the Long-Term Consolidation in Banking

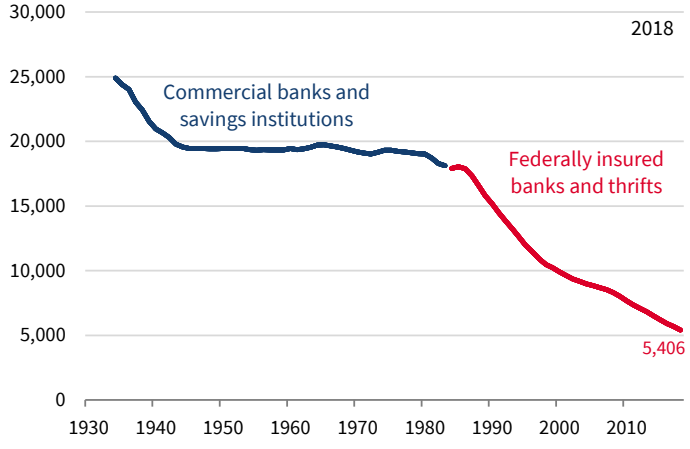
The number of federally insured banks and savings institutions declined from 18,033 at the end of 1985 to 5,406 at the end of 2018, a total decline of 70 percent. This consolidation has been characterized by two main features. First, there has been a dramatic decline in the number of very small institutions, those with assets less than $100 million. In 1985, there were 13,631 institutions with assets less than $100 million, making up 76 percent of federally insured banks and thrifts. By 2018, this number had declined to just 1,278, making up just 24 percent of all banks and thrifts. Some 98 percent of the net decline in federally insured institutions over this period took place among banks with less than $100 million in assets.

This decline of the smallest banks can be attributed in large part to economies of scale in banking. A rough measure of economies of scale is the difference in total noninterest expenses as a percentage of average assets for banks in different size categories. FDIC-insured community banks reported a noninterest expense ratio of 2.75 percent in 2018, compared with 2.59 percent for the larger noncommunity banks. This 16-basis-point difference in overhead expenses translates into expenses that were $3.5 billion higher than they would have been at the ratio reported by noncommunity banks. This figure represents more than 13 percent of community bank net income in 2018.

Hughes and others (2018) compare average operating costs and costs associated with overhead, reporting and compliance, and telecommunica-

Figure 6-ii. Consolidation in U.S. Banking and Thrift Industries, 1934–2018

Number of institution charters at the end of the year



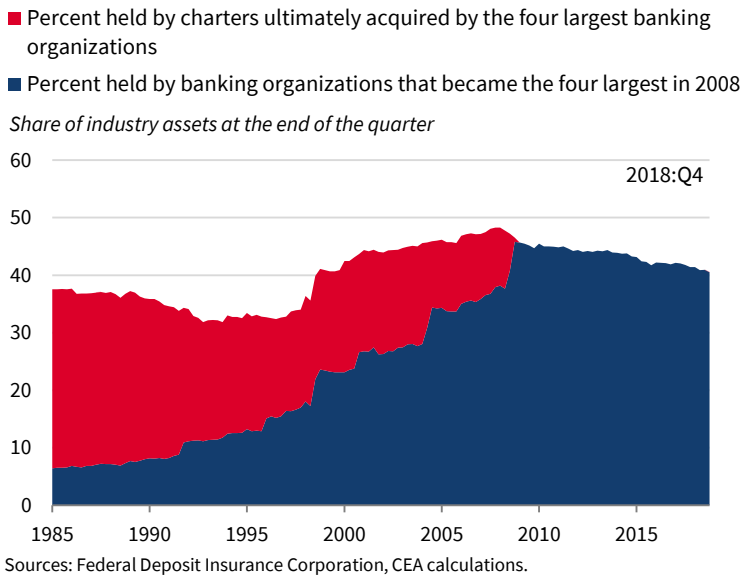
Sources: Federal Deposit Insurance Corporation; Federal Home Loan Bank Board; Federal Deposit Insurance Corporation.
Note: Data for commercial banks and savings institutions are from historical sources. Data for federally insured banks and thrifts are from call reports and thrift financial reports.

tions across three asset size categories. They show that large community banks and midsized banks both have efficiency advantages over small community banks. Looking back to the mid-1980s, we see that total noninterest expenses as a percentage of average assets have diverged from what was rough parity in the late 1990s to an advantage of up to 100 basis points for the largest banks by 2017. Larger banks may benefit from economies of scale in absorbing the costs of technology and regulatory compliance, both of which have become more important over time.

The second main feature of banking industry consolidation since the mid-1980s has been the emergence of a few very large institutions that have absorbed large shares of industry assets. The share of industry assets held by the four largest banking organizations rose from 11 percent in 1985 to 40 percent at the end of 2018. Here, too, economies of scale have played an important role. The ratio of noninterest expenses to total assets for banks larger than $250 billion in total assets fell by more than 100 basis points between 2000 and 2018.

Consolidation since 1985 has come about through failures (2,619 between the end of 1985 and the end of 2018), intercompany mergers (8,722 since 1985), and intracompany consolidation of charters (5,123 since 1985). Most of the failures took place during two crisis periods, first in the 1980s and early 1990s, and then following the financial crisis of 2008. Voluntary

Figure 6-iii. Share of Industry Assets Held by U.S. Banking Organizations That Became the Four Largest by 2008, 1985–2018



Sources: Federal Deposit Insurance Corporation, CEA calculations.

mergers and charter consolidations during this period were spurred not only by the prospect of economies of scale but also by the decline in regulatory restrictions on branching and interstate banking. Geographic deregulation facilitated the formation of larger, more efficient banks. Though this promoted greater efficiency and opportunities for diversification, it also helped create large, complex banks that have benefited from the perceived implicit government support of systemically important banks (figures 6-ii and 6-iii).

There are a number of pending regulatory proposals to implement the provisions of S.2155. Taken together, Titles I though IV of the act represent a new approach to regulating financial institutions that reflect the Core Principles delineated at the outset of this Administration. They will relieve community and regional banks from excessive and costly regulatory requirements that should really only apply to SIFIs. Moreover, they preserve the elements of regulatory reform that were designed to contain the systemic risks that led to the financial crisis of 2008. But they take an approach that appropriately tailors regulatory requirements according to the activities and structure of the bank, and the level of risk that it poses to financial stability.

Signing the bipartisan S.2155 bill into law is the most visible reform yet put into place by President Trump. This act is expected to have a range of long-term benefits for financial institutions, the economy, and the public. It levels the competitive playing field between the smaller community banks and credit unions and the larger, more complex financial institutions. It recognizes the vital importance of small and midsized banks, as well as the high costs and negligible benefits of subjecting them to regulatory requirements better suited for the largest financial institutions. S.2155 is expected to reduce regulatory burdens and help to expand the credit made available to small businesses that are the lifeblood of local communities across the nation.

Additional steps taken to address regulatory concerns. As important as S.2155 is in scaling back costly and unnecessary regulations, a number of other, less well-known measures have been adopted that also represent progress in implementing the Administration's agenda.

Addressing the CFPB's arbitration rule was one crucial step. In July 2017, the CFPB released a rule intended to ban certain financial companies from using mandatory arbitration clauses in consumer contracts, and to permit consumers to participate in class action lawsuits. But the new rule was later reconsidered after it was shown to adversely increase the cost of credit for consumers. In November 2017, the rule was nullified under the Congressional Review Act after a joint resolution to do so was signed into law by President Trump.

Another priority is reform of the Community Reinvestment Act (CRA). In 1977, the CRA was enacted to encourage banks to meet the credit needs of all segments of their communities, including low- and moderate-income households. In response to growing feedback—including from the Department of the Treasury—that the CRA requires modernizing (especially with the rise in online banking), in August 2018 the OCC published its Advanced Notice of Proposed Rulemaking to seek input on the best ways to update the regulatory framework that supports the CRA. To improve credit availability in the areas most in need, the OCC is soliciting input on topics such as how to improve the current approach to performance evaluations, expand the activities that qualify for CRA, and better define communities.

The data collection rule under the Home Mortgage Disclosure Act also needs improvement. In 2015, the CFPB had issued an update to the 1975 Home Mortgage Disclosure Act, which expanded data disclosure requirements for lending institutions. The new rule, which was set to go into effect January 1, 2018, was delayed pending a review of and improvements to the CFPB's data security systems. The CFPB, with interagency assistance, concluded that its "security posture is well-organized and maintained," and it has recently sought comments from relevant parties as it considers whether changes to its data governance and data collections programs would be appropriate. It seeks to balance the protection of privacy without hindering its ability to accomplish its objectives and statutory mandate.

Another needed initiative is updating the commercial real estate appraisal rule. In a coordinated effort between the OCC, the Federal Reserve, and the FDIC, effective in April 2018, the threshold for commercial real estate appraisals was raised from $250,000 to $500,000. The rule amends Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, partly in response to concerns among relevant stakeholders that the prior threshold level did not reflect the appreciation of commercial real estate in the 24 years since the threshold was initially set. The three agencies determined that the increased appraisal level would materially reduce regulatory burden and the amount of transactions requiring an appraisal, while not sacrificing the safety and soundness of financial institutions.

The regulatory capital rule for small banks, with respect to transitions, is another improvement. The OCC, the Federal Reserve, and the FDIC adopted a final "Transitions Rule" that extends the 2017 regulatory capital treatment for certain items for smaller banks. The relief provided under this rule specifically applies to banking organizations that are not subject to the capital rules' advanced approaches, which tend to be smaller banks. This rule went into effect on January 1, 2018.

And finally, the regulatory capital rule for small banks, with respect to simplifications, is being considered. The "Simplification Rule"—which was proposed by the OCC, the Federal Reserve, and the FDIC in October 2017—would

aim to simplify compliance with certain aspects of the capital rule, particularly for smaller banks.

Conclusion

This chapter has chronicled the financial crisis of 10 years ago—its causes, its costs, and its consequences. The financial crisis of 2008 was the most severe systemic financial event in the U.S. since at least the 1930s. It was a self-reinforcing crisis that arose within the financial industry itself but soon spread to the wider economy. The crisis exposed weaknesses in institutional and regulatory structures that were in dire need of reform. Before it was over, the Federal government was required to provide assistance to financial institutions that was unprecedented in its scale and its scope.

Notwithstanding this extraordinary support, the crisis took a heavy toll on U.S. economic activity that affected the vast majority of Americans. The declines in manufacturing, construction, employment, and overall economic activity that came after the crisis were historically large and long lasting. These economic effects underscored the need for an appropriate regulatory response that would enhance the stability of financial markets and institutions, and would protect the American people from the consequences of enduring a future crisis.

The Financial Crisis Inquiry Commission was organized in 2009 to examine the causes of the crisis and inform the regulatory reforms that were sure to follow. The FCIC released a 662-page report in January 2011 documenting the various factors that exacerbated the financial crisis. This report did not receive bipartisan support. But it did provide first-hand accounts of a wide range of bankers, regulators, and analysts that could have been considered as reforms were being planned. Yet even before this report was published, Congress passed the 2010 Dodd-Frank Act—a sweeping overhaul of financial regulation that did not result in a rapid economic recovery and that has had a number of unintended consequences.

The Dodd-Frank Act has proven to be a misguided approach to regulatory reform. It called for almost 400 new rules, not all of which have been implemented. The act placed unnecessary burdens on banks and their customers through its frequent overreach and its prescriptive approach to regulation. There is a growing body of evidence that Dodd-Frank's one-size-fits-all approach has been very costly for community banks and for the small businesses that depend on them for credit. Studies confirm the economies of scale that are associated with regulatory compliance, and support the notion that postcrisis regulatory changes have had a disproportionate effect on small and midsized banks. This regulatory approach has had substantial economic consequences. The average pace of economic growth in the first eight years of the expansion, through 2016, was the slowest of any U.S. expansion since 1950.

Dodd-Frank was especially problematic in discouraging small business lending and in promoting consolidation among small and midsized banks. Although community banks had little to do with the onset of the financial crisis, their numbers have fallen by more than 2,400, or one-third, since 2008. FDIC data show that community banks are vitally important to communities that are not served by larger institutions. They also make small business loans in proportions that are almost three times higher than their share of total industry loans. Similarly, the importance of small businesses for the U.S. economy goes well beyond the roughly two-thirds of new jobs they typically create. Small businesses have traditionally been a source of strength for their communities and a source of innovation where new and different ideas can be pursued. They spark innovation. And they rely heavily for funding on community banks, which have a local focus that helps them meet their credit needs.

From its first days, the Trump Administration outlined a more informed approach to financial regulation that will make the Nation's financial system more efficient and more effective. Seven Core Principles for financial regulation were outlined at the outset of the Administration, calling for an end to taxpayer bailouts, a more accountable regulatory framework, more and better analysis before imposing new regulations, a leveling of the competitive playing field between U.S. and foreign banks, and other steps to enable Americans to make their own informed financial decisions in a stable financial system. From the start, it was emphasized that well-reasoned financial reforms would be essential to bring the pace of the United States' economic growth and its standard of living up to their true potential.

During the past two years, the Department of the Treasury has issued four reports that made detailed recommendations consistent with the Administration's Core Principles. With regard to depository institutions, the Treasury has recommended a series of changes designed to simplify regulations and reduce their implementation costs, while maintaining high standards of safety and soundness and ensuring the accountability of the financial system to the American public. These recommendations have been discussed at length in this chapter.

A number of these recommendations were implemented in the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018, which was enacted in May 2018 and is generally referred to as S.2155. The act addresses some of the most important shortcomings associated with Dodd-Frank, and does so in a way that does not undermine the safety and soundness of the banking industry. It provides regulatory relief to small banks by recognizing their judgment in terms of the mortgage loans they hold, simplifying their capital requirements, and giving them a presumption of compliance with regard to proprietary trading, which few of them do in the first place.

Most importantly, S.2155 scales back the heightened regulatory standards that were applied to midsized banks—those with assets between $50

billion and $250 billion—that were treated as systemically important banks under Dodd-Frank. As a result, more than 30 midsized and regional banks that hold 22 percent of industry assets can get relief from unnecessary regulatory standards that would otherwise limit their ability to grow, prosper, and serve their customers. This change is an example of how a one-size-fits-all approach is giving way to "tailored" regulatory standards that are matched to the actual level of risk imposed by each institution.

The Administration's agenda is ambitious, and its accomplishments thus far are many. This effort is part of the Administration's overall push, along with other forms of deregulation (see chapter 2) and tax reform (see chapter 1) to reverse the historically slow economic growth of the immediate postcrisis period, and to enhance the performance of the economy so it can reach its true potential. The election of President Trump in November 2016 produced an immediate increase in small business confidence that has remained in place ever since. The pace of economic activity has quickened during the Administration's first two years. After the enactment of the Tax Cuts and Jobs Act, real economic growth rose to an annualized rate of more than 4 percent for the first time in four years. The recovery in business confidence, hiring, and investment spending since 2016 suggests that we will see higher potential growth in the years ahead.

Most important, these commonsense adjustments to the financial regulatory framework signal an end to the war on Wall Street that took place in the immediate aftermath of the 2008 financial crisis. The implicit support for the largest banks and the government-sponsored enterprises has been rolled back by the reforms enacted thus far. The diverse U.S. financial system will continue to include elements that meet the needs of corporations, of Main Street, and of everyone and everything in between. A smoothly functioning and prosperous financial industry has long been one of the pillars that has supported the development of the U.S. economy into the largest and most stable in the world. The sensible financial reforms being pursued by the Trump Administration suggest that this institutional strength is back, and will endure in the decades to come.